PEER REVIEWED ARTICLE

Transfer Pricing Aspects of Intra - Group Loans in Light of the Base Erosion and Profit Shifting Action Plan

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This article primarily focuses on transfer pricing aspects of intercompany loans. The analysis will take into consideration the current Organisation for Economic Co-operation and Development OECD transfer pricing guidelines as well as the revised transfer pricing guidance issued under the OECD/G20's Base Erosion and Profit Shifting (BEPS) Action Plan. Moreover, the impact of other BEPS related actions on intercompany loans and their relationship with transfer pricing rules is discussed. Finally, the author concludes by making a suggestion to the OECD to adopt his analysis when providing transfer-pricing guidance on intercompany loans.

1 Introduction: Intercompany Loans

1. Over the past decade, tax authorities from several jurisdictions have significantly increased their focus on transfer pricing aspects of cross-border related party financial transactions[1] such as intercompany loans, financial guarantees[2] and cash pooling arrangements[3]. This attention is especially evident in the international arena where cross-border debt financing can lead to Base Erosion and Profit Shifting (BEPS).

2. Article 9 of the Organisation for Economic Co-operation and Development (OECD) Model[4] endorses the arm's length principle for pricing transactions between associated enterprises. This means that, from a transfer pricing perspective, intercompany loans among associated enterprises have to be at arm's length. It should be noted that Article 9(1), by itself, does not authorize States to make arm's length primary adjustments (structural or price adjustments). The adjustment provisions have to be authorized by the domestic law of the State. Article 9(1), on the other hand, restricts the application of such domestic law provisions. This implies that profits of associated enterprises can only be adjusted up to arm's length conditions or an arm's length profit[5].

3. The purpose of this contribution is to discuss as to when an intercompany loan can be considered to be at arm's length? To answer this question, the author initially discusses the situations wherein a loan arrangement can be re-characterized or disregarded in the borrowers State under the arm's length principle. When recognized, the author proposes a two-step approach to undertake an arm's length

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1 A. Bakker, *Transfer Pricing and Intra Group Financing: Low-Hanging Fruit?*, 15(2) Derivatives & Fin. Instruments 27 (2013); A. Russo & O. Moerer, *Introduction* in *Transfer Pricing and Intra Group Financing* 40–41 (IBFD 2012); S. Damji, I. Diakonova & U. Brügger, *Transfer Pricing DNA as a Tool to Achieve the Optimal Balance of Risks and Efficiency*, 3 Der Schweizer Treuhänder 185 (2006); D. Ledure et al., *Financial Transactions in Today's World. Observations from a Transfer Pricing Perspective*, 38(6/7) Intertax 350–352 (2010).

2 V. Averyanova & J. Sampat, *Transfer Pricing Aspects of Intra-Group Financial Guarantees in Light of the BEPS Action Plan*, 22(6) Intl. Transfer Pricing J. 361–368 (Oct. 2015).

3 V. Chand, *Transfer Pricing Aspects of Cash Pooling Arrangements in Light of the BEPS Action Plan*, 23(1) Intl. Transfer Pricing J. 38–47 (Jan./Feb. 2016).

4 OECD, *Model Convention with Respect to Taxes on Income and on Capital*, *(OECD Model) (2014)*, Art. 9. Specifically, Art. 9(1) allows tax authorities of a State to adjust the profits of the enterprises resident in that State, if as a result of the special relations between that enterprise and other associated enterprises resident in other States, the profits of the first enterprise have been diverted to the other associated enterprises, due to the fact that they operate with each other on a non-arm's length basis. Art. 9(2) aims at eliminating the economic double taxation that may arise pursuant to Art. 9(1). Similar provisions are found in the UN Model. Further, it should be noted that the UN Model contains an additional paragraph viz., Art. 9(3) which relieves the tax authority of a State from making corresponding adjustments when one of the associated enterprises, as a result of the primary adjustment, is liable to penalty with respect to fraud, gross negligence or willful default. *See* UN, *Model Double Taxation Convention between Developed and Developing Countries*, *(UN Model) (2011)*, Art. 9.

5 A. Bullen, *Arm's Length Transaction Structures: Recognizing and Restructuring Controlled Transactions in Transfer Pricing* 67–78 & 356–357 (IBFD Doctoral Series 2011); On the other hand, another commentator argues that Art. 9(1) does not authorize structural adjustments. *See* J. Wittendorff, *The Transactional Ghost of Article 9(1) of the OECD Model*, 63(3) Bull. Intl. Taxn. 110–114 (2009).

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analysis of intercompany loans. Moreover, the question also arises as to when a lender should be allocated the returns with respect to the debt funding? The analysis will be done in light of the current OECD transfer pricing guidelines[6] and the revised guidance issued pursuant to the BEPS Action Plan[7], in particular, Action 8–10[8]. The impact of Action 13 on financing arrangements will also be discussed[9] (*see* section 2). Subsequently, the impact of other BEPS related actions (and recent European Union [EU] developments) from a borrower and lender perspective, on intra-group loans is put forward and their relationship with transfer pricing rules is examined (*see* section 3). Finally, the author concludes by discussing the way forward (*see* section 4).

2 Transfer pricing aspects of intercompany loans in light of the BEPS action plan

2.1 *Borrowers State: Non Recognition of Loans*

2.1.1 *Is It a Loan for Domestic Law Purposes?*

4. At the outset, the question arises as to under what situations can intercompany loans be re-characterized or non-recognized from the borrowers State's perspective? In the author's opinion, when dealing with intercompany loans, as an initial step it needs to be ascertained as to whether the funding arrangement qualifies as a loan or something else (such as equity) for domestic law purposes[10]. For instance, from a Dutch perspective, loans are generally recognized under civil law relations i.e. the form over substance approach. However, under established case law, loans are considered to be equity when the facts and circumstances indicate that (1) the loan is essentially a disguised capital contribution, (2) the loan gives the lender a right to participate in the borrowers business (profit participating loan) or, (3) when the receivable arising from the loan has no or little value since the outset (loan without any repayment clauses)[11].

2.1.2 *Re-characterization of Loans Under the Arm's Length Provision*

2.1.2.1. Article 9(1): Re-characterization of Debt to Equity

5. Even if the loan arrangement is recognized for domestic law purposes, the question arises as to whether Article 9(1) allows a State to re-characterize the loan arrangement (entire arrangement or a part of the arrangement) between associated enterprises if it is not at arm's length[12]? The OECD, in light of its report on thin capitalization[13], is of the view that Article 9(1) '*is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital*'[14].

6. However, this position has been criticized in academic literature. It is stated that Article 9(1) can only be used to determine whether the interest rate charged on loans between associated enterprises

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6 OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines)* (OECD 22 July 2010).

7 OECD, *Action Plan on Base Erosion and Profit Shifting* (OECD 2013).

8 These Actions have led to changes in Ch. I (guidance for applying the arm's length principle), Ch. II (Transfer Pricing Methods), Ch. VI (Intangibles), Ch. VII (Intra Group Services) and Ch. VIII (Cost Contribution Arrangements). *See* OECD/G20, *BEPS, Aligning Transfer Pricing Outcomes with Value Creation, (OECD Revised Guidelines on Action 8–10) (*OECD/G20 05 Oct. 2015).

9 This Action has led to changes in Ch. V (Transfer Pricing Documentation). *See* OECD/G20, *BEPS, Transfer Pricing Documentation and Country by Country reporting, (OECD Revised Guidelines on Action 13) (*OECD/G20 05 Oct. 2015).

10 The 1979 OECD Transfer Pricing guidelines acknowledged that for tax reasons equity contributions could be disguised as loans and thereafter laid out the various approaches followed by the OECD member countries to distinguish between equity and debt. The guidelines recommended that a flexible approach should be followed by States to reclassify debt to equity. This approach would take into consideration various factors to determine whether debt is actually equity. The factors include 1) whether the principal amount of the loan is payable at a future date, 2) whether the loan is subordinated to the rights of other creditors, 3) whether the debt is convertible to equity, 4) whether the parties intended to create a debtor-creditor relationship & 5) whether the debt-equity ratio exceeds a certain percentage etc. The guidelines provided that it would not be desirable, to use a hard and fast debt equity ratio to convert debt to equity. *See* OECD, *Transfer Pricing and Multinational Enterprises (OECD 1979 Guidelines)* (1 June 1979), paras 184–191; *Also see* para. 25, *OECD Model: Commentary on Article 10* (2014).

11 J. Reyneveld & M. Bonekamp, *Non Business Motivated Loans: Considerations from an Economic Perspective*, 19(3) Intl. Transfer Pricing J. 227–228 (2012); A. Bobeldijk & R. Velden, *The 'Non-Businesslike Loan': A New Doctrine for the Tax Treatment of Equity and Debt Capital in the Netherlands*, 43(3) Intertax 277–278 (2015); Similar rules exist in other countries. For Australia – *see* P. Balkus & M. Heath, *Australia* in *Transfer Pricing and Intra Group Financing* 66–68 (IBFD 2012). For USA – *see* M. Calva, K. Chandrasekhar & M. Gaffney, *United States* in *Transfer Pricing and Intra Group Financing* 530–532 (IBFD 2012).

12 The domestic law should authorize the structural adjustment. For a detailed discussion on whether or not Art. 9(1) allows for a structural adjustments *see* Bullen, *supra* n. 5, at 231–273.

13 OECD, *Thin Capitalization)* (26 Nov. 1986), paras 48–49.

14 *See* para. 3(b), *OECD Model: Commentary on Article 9* (2014).

is at arm's length or not and cannot be used to re-characterize debt to equity. The view is based mainly on a literal reading of Article 9(1) which provides that adjustments can be made for '*conditions … made or imposed … between the two enterprises in their commercial or financial relations*'. It is argued that an examination of the contracted terms which have already been made or imposed needs to be undertaken for the purpose of Article 9(1) rather than the entire contract itself. Put differently, the term '*conditions … made or imposed*' only refers to the terms of the contract (such as interest rate) and not to the existing financial relations between the associated enterprises. Thus, Article 9(1) would not permit a re-characterization of debt to equity[15].

7. On the contrary, other commentators suggest that the view proposed against such re-characterization is extremely narrow as Article 9(1) is broad and indeed covers situations where debt can be re-characterized as equity. This is because the word '*imposed*' in relation to the word '*conditions*' indicates that not only the contractual terms but also other terms i.e. the overall financial relations of the associated enterprises are to be taken into consideration[16]. The author agrees with this line of reasoning and suggests that Article 9 (1) should be interpreted broadly and the word '*imposed*' in relation to the word '*conditions*' in the sentence '*conditions … made or imposed … between the two enterprises in their commercial or financial relations*' indicates that not only the contractual terms but also other terms i.e. overall financial relations of the associated enterprises are to be taken into consideration. In the next section, the author discusses situations wherein a loan arrangement can be re-characterized.

2.1.2.2 Loans Exceeding the Borrowers Borrowing Capacity

8. The current guidelines (in Section D of Chapter I) provide that tax administrations should analyse a transaction as structured and undertaken by the taxpayer. However, in two exceptional cases, tax administrations may disregard the actual transaction or substitute it for alternate transactions.[17] The first circumstance arises when the form and economic substance of a transaction do not coincide. This is illustrated through a thin capitalization example. In that example one related party provides an interest-bearing loan to another related party even though the latters '*relevant economic circumstances*' indicate that the investment would not be structured in the form of a loan. In such circumstances, the tax authorities may characterize the arrangement in accordance with its substance and treat the funding as a capital contribution[18].

9. The revised guidance also states that the application of the arm's length principle requires a comparison of the related party transactions with comparable uncontrolled transactions. Two features of this analysis are to: (1) identify the commercial or financial terms between related parties and the economically relevant aspects attached to such terms in order to properly delineate the related party transactions, and (2) undertake a comparability analysis to compare the controlled transactions with uncontrolled transactions.[19] The first step requires an analysis of the commercial or financial relations of the controlled transaction. Specifically, the focus is set on identifying the '*economically relevant characteristics*' of these commercial or financial relations. These characteristics comprise of (1) the contractual terms of the transactions, (2) a functional analysis, (3) the characteristics of the property transferred or services provided, (4) economic circumstances of the parties and the market in which the parties operate and (5) the business strategies pursued by the parties[20]. The identification of these characteristics is essential because independent parties look into these characteristics in order to make decisions about whether or not to enter into a transaction. Moreover, independent parties consider the other options realistically available to them in light of these characteristics, and they will '*only enter into the transaction if they see no alternative that offers a better opportunity to meet their commercial objectives*'[21]. Essentially, when the commercial or financial relations

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[15] F. Hosson & M. Michielse, *Treaty Aspects of the 'thin capitalization' Issue – A Review of the OECD Report*, 17(11) Intertax 480 (1989); Wittendorff, *supra* n. 5, at 115–120.

[16] L. De Broe, *International Tax Planning and Prevention of Abuse* 505 (IBFD Doctoral Series 2008).

[17] OECD Guidelines, para. 1.64.

[18] OECD Guidelines, para. 1.65. This example is deleted in the revised guidance. *Also see* OECD 1979 Guidelines, para. 23.

[19] *OECD Revised Guidelines on Action 8–10*, para. 1.33.

[20] *Ibid.*, para. 1.36.

[21] *Ibid.*, para. 1.38.

agreed between associated enterprises are not aligned with the economically relevant characteristics (or economic substance), tax authorities may delineate the transaction based on '*the characteristics of the transaction reflected in the conduct of the parties*'[22] (its economic substance)[23].

10. Interestingly, the question arises as to how do we determine the borrowers '*relevant economic circumstances*' or '*economically relevant characteristics*' to determine if a loan is to be provided in an arm's length situation? In the author's opinion, the '*could*' analysis can be used to answer this question. The analysis, which is seen from the lenders perspective, addresses the following question[24]: *could* the borrowing entity obtain a similar level of debt from a third party lender? Specifically, the analysis focuses on what a lender would be prepared to lend to the borrower taking into consideration the latters (including but not limited to) features such as (1) capacity to borrow, (2) risk of default, (3) assets that can be provided as securities, (4) liabilities that can have a negative effect on the intercompany loans, and (5) the industry in which the borrower operates and (6) the borrowers debt service ability. Essentially, at the core of the *could* analysis, a credit rating evaluation[25] of the borrower on a standalone basis, as adjusted for implicit support, is required to be undertaken (*see* section 2.2.1). The analysis, will lead to understanding the debt capacity of the borrower.

11. If all the facts and circumstances, after undertaking the analysis, indicate that independent parties (such as banks) would lend to the borrower then the borrowers State should not re-characterize the borrowing transaction. On the contrary, if all the facts and circumstances indicate that independent parties would not lend to the borrower, as the borrowers credit rating would not support the loan amount and the terms and conditions on which it is provided then the tax authorities in the borrowers State may re-characterize the borrowing transaction to reflect an arm's length amount[26]. For instance, consider the following example: The *could* analysis of Company C indicates that it has an overall arm's length borrowing capacity of USD 1,000. However, its related party, Company B, grants it a loan amounting to USD 1,500. As independent lenders would grant Company C a loan of only USD 1,000, the excess amount of USD 500 should be re-characterized. As stated previously, the re-characterization may take the form of a capital contribution[27].

2.1.2.3 Commercially Irrational Loans

12. Furthermore, the current guidance (second circumstance)[28] as well as revised guidance provides that the related party transaction can be disregarded and replaced with another arrangement if the related party arrangement, viewed holistically, differs from those which would have been adopted by independent enterprises behaving in '*a commercially rational manner*' thereby preventing the determination of a price that would be acceptable to both parties taking into account their respective perspectives and their realistically available options[29].

13. In the present context, the question arises as to whether an intercompany loan can be disregarded even if the borrowers borrowing capacity would support an arm's length debt and interest? In the

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22 *Ibid.*, para. 1.120.

23 The current guidance, in the chapter that deals with business restructurings, also provides that re-characterization can take place when economic substance of the transaction or arrangement differs from its form. Substance is determined by '*examining all of the facts and circumstances, such as the economic and commercial context of the transaction or arrangement, its object and effect from a practical and business point of view, and the conduct of the parties, including the functions performed, assets used and risks assumed by them*'. *See* OECD Guidelines, para. 9.170.

24 Russo & Moerer, *supra* n. 1, at 15; Damji, Diakonova & Brügger, *supra* n. 1, at 189.

25 This evaluation estimates the ability of the borrowing entity to repay its debt.

26 It could be argued that the related borrower, due to its limited financial means, would not have been able to borrow the funds from an independent lender. Accordingly, in circumstances where related lenders provide the loan even though the related borrowers financial position will not be able to support it, appropriate recharacterizations can be made to reflect the increased risk of the lender. *See* Bullen, *supra* n. 5, at 463–469.

27 Bullen, *supra* n. 5, at 469. Such recharacterization should be restricted to the loan arrangement and does not warrant an entire re-characterization of the borrowers capital structure. Moreover, the amount of adjustment must be restricted to an arm's length amount. For instance, the interest amount on the loan exceeding the borrowers borrowing capacity is disallowed as a deduction as opposed to disallowing the entire interest amount. Bullen, *supra* n. 5, at 471–472.

28 OECD Guidelines, para. 1.65.

29 *OECD Revised Guidelines on Action 8–10*, para. 1.22. *Also see* OECD Guidelines, paras 9.171–9.179. At the outset, it should be noted that Art. 9(1) states that the terms and conditions of related party transactions should be compared with terms and conditions of unrelated party transactions. There is no reference to conditions made by independent enterprises behaving in a '*commercially rational manner*'. Therefore, this does not seem to be an appropriate arm's length test. *See* M. Lange, P. Lankhorst & R. Hafkenscheid, *(Non-) Recognition of Transactions Between Associated Enterprises: On Behaving in a Commercially Rational Manner, Decision Making Traps and BEPS*, 22(2) Intl. Transfer Pricing J. 85–86 (2015).

author's opinion, the '*would*' analysis can be used to answer this question. The analysis, which is seen from the borrowers perspective, addresses the following question[30]: *would* the borrowing entity actually borrow a similar amount at arm's length given the performance of its business? Specifically, the analysis focuses on under what conditions a borrower would have borrowed at arm's length taking into consideration (including but not limited to) features such as (1) its financial situation, (2) the amount of debt and whether taking that amount leaves room to absorb cyclical or seasonal variations, unforeseen events or a fluctuation in interest rates or profits, (3) its costs of borrowing, (4) its debt servicing ability and the possibility to have sufficient cash to operate as a profitable organization, and (5) whether the borrower would have taken the loan at all.

14. If all the facts and circumstances, after undertaking the analysis, indicate that the borrower would have entered into the transaction then the loan should be respected. On the contrary, if all the facts and circumstances indicate that the borrower would not enter into the transaction then the loan may be re-characterized. For instance, consider the following example: Company C has an overall arm's length borrowing capacity of USD 1,000. Till date, it has borrowed funds up to USD 600 from its related party (for undertaking commercial activities). Its un-used arm's length borrowing capacity amounts to USD 400. Consequently, in order to maximize the amount of deductible interest available to it, Company C decides to increase its related party debt to achieve a level closer to an arm's length amount even though there is no commercial or business need to do so. Accordingly, Company C borrows funds from its related party viz., Company B. The principal reason to take a loan is to generate an interest deduction. On one hand, the taxpayer could argue that the loan should not be disregarded, as the debt and interest amount does not exceed the borrowers borrowing capacity[31]. However, on the other hand, the tax authorities could argue that the borrower did not need a loan and used it solely to generate interest deductions. Moreover, the transaction was entered into only due to the group relationship[32]. Consequently, there is no '*commercial rationale*' for the loan arrangement.

15. In the author's opinion, the loan of USD 400 can be re-characterized if the taxpayer is not able to demonstrate the business rationale for the loan. Nevertheless, as long as the borrower can demonstrate the commercial rationality for which it needs a loan (such as for undertaking commercial activities) then the author's opinion is that the transaction should not be disregarded[33]. Accordingly, the threshold for disregarding the transaction under the '*commercially rational*' standard is high[34].

2.2 *Setting Arm's Length Prices*

2.2.1 *Borrowers Credit Rating*

16. Once the loan funding arrangement is recognized, a two-step process[35] needs to be undertaken to conduct a transfer pricing analysis of intercompany loans. Firstly, the relevant economic characteristics of the borrowing entity need to be established, in particular, a credit rating evaluation of the borrowing entity is required to be done. Secondly, an arm's length interest rate needs to be determined. The arm's length interest rate, fixed or floating, consists of a base rate (risk free rate) that is determined on the basis of currency and maturity and a credit spread[36] that is determined on the basis of the risks undertaken by the lender with respect to the lending transaction[37].

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30 Russo & Moerer, *supra* n. 1, at 15; Damji, Diakonova & Brügger, *supra* n. 1, at 189.

31 Bullen, *supra* n. 5, at 465.

32 *See* Her Majesty Revenue and Customs, *Transfer Pricing: Thin Capitalization Legislation and Principles*, INTM 413030.

33 *OECD Revised Guidelines on Action 8–10*, para. 1.123.

34 Lange, Lankhorst & Hafkenscheid, *supra* n. 29, at 88.

35 Damji, Diakonova & Brügger, *supra* n. 1, at 187; Russo & Moerer, *supra* n. 1, at 15.

36 The OECD Guidelines provide that '*in respect of financial services such as loans … remuneration would generally be built into the spread and it would not be appropriate to expect a further service fee to be charged*'. OECD Guidelines, para. 7.15.

37 For features of third party interest rates *see* – Her Majesty Revenue and Customs, *Thin capitalization: Practical Guidance*, INTM 522040.

17. To reiterate, the *could* analysis entails an estimation of the borrowers credit rating[38]. The question arises as to what how does one determine the credit rating of an entity? The best-known credit rating agencies are Standard and Poor, Fitch and Moody's although other agencies also exist (such as Dominion). In general, these agencies (and banks) assign credit ratings on the basis of qualitative and quantitative factors such as business/industry analysis in which the borrower operates, operational risk assessment of the borrower, financial statement analysis, cash flow analysis, forecast and probability measurement analysis, credit scoring analysis and comparable analysis.[39] The credit rating (expressed in terms of letters such as A – excellent, B – moderate, C – poor and D – already in default) obtained pursuant to the multi-pronged creditworthiness analysis lays the foundation to determine under what conditions can a loan be issued in related party settings. These agencies have also developed credit rating models that can be licensed by companies (taxpayers). The companies can use these models themselves to quickly estimate credit ratings on a cost effective basis (in house ratings). These models give a reasonable estimation of the borrowers credit rating even though they do not provide in depth analysis that an independent credit rating agency will carry out. From a transfer pricing perspective it becomes essential that the in-house rating is tested to see whether the data and assumptions put into place, produce a reasonable reliable outcome[40].

18. Furthermore, the question arises as to whether the credit rating of a borrower needs to be adjusted for implicit support. The revised OECD guidance discusses the following example (slightly modified by the author). S is an entity with a *Baa* rating on a standalone basis. With this rating, S is able to obtain loans at an interest rate of 9%. However, as S is a member of a multinational group, an independent lender lends to S at an interest rate of 7% – the rate that the lender would charge to borrowers with a credit rating of *A.* At the same time, S obtains a loan from a related party lender viz., T at rates applicable to borrowers with an *A* rating i.e. at an interest rate of 7% (all loan terms and conditions being similar). The question arises as to whether the interest rate charged by T to S is at arm's length? The revised OECD guidance answers the question in the affirmative because the rate charged by T to S is the same as the rate charged by an independent lender to S. Moreover, it is stated that payment or comparability adjustments need not be undertaken for the incidental (synergistic) benefit that S enjoys from being a part of the multinational group, that is, its ability to obtain a loan from an independent lender at lower interest rates. Accordingly, the act of raising S's credit rating of few notches upwards by including the synergistic benefit is justified[41].

19. Likewise, in the context of analysing the question of whether the provision of a guarantee amounts to an intra-group service, the revised OECD guidance provides that an intra-group service is provided when the provision of formal guarantee (a deliberate concerted action by the parent) enhances the credit rating of the subsidiary (for instance from *A* to *AAA)* that thereby enables it to obtain a loan at a lower rate (for instance at an interest rate of 5% – the rate applicable to borrowers with a *AAA r*ating)[42]. On the contrary, if the subsidiary has a higher credit rating (for instance – *A*) due to its group membership than the credit rating it could achieve on an individual basis (for instance – *Baa*) then no service is provided by the parent to the subsidiary as the latter company only receives an incidental benefit by being associated with the group[43]. In the former situation, guarantee fee is justified whereas in the latter it is not. It is clearly stated that the guarantee fee shall reflect the benefit of raising the subsidiaries credit rating from *A* to *AAA.* On the contrary, the uplift from *Baa* to *A* is attributable to a synergistic benefit. Once again, in this example, the standalone credit rating of the taxpayer is

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38 The Finnish – *OY* and Australian – *Chevron* judgment (discussed in s. 2.2.4), confirm this position. Moreover, in the context of guarantee fees, the Canadian Court in the *GE capital case* stressed on the credit rating of the borrower. *See* General Electric Capital Canada, *Inc. v. Her Majesty The Queen* 2009 TCC 563, aff'd 2010 FCA 344. *Also see* E. Kamphuis, *How to Deal with Affiliation in Interpreting the Arm's Length Principle: The GE Case Reviewed*, 17(4) Intl. Transfer Pricing J. 292–297 (2010); I. Verlinden, P. Boone & C. Dunn, *Transfer Pricing Practice in an Era of Recession*, 17(1) Intl. Transfer Pricing J. 328–329 (2009).

39 For a detailed description of these parameters *see* Russo & Moerer, *supra* n. 1, at 16–30. *Also see* Reyneveld & Bonekamp, *supra* n. 11, at. 229–232. The comparable analysis could be undertaken by benchmarking against capital structures of comparable companies.

40 Her Majesty Revenue and Customs, *Thin Capitalization: Practical Guidance*, INTM 524070.

41 *OECD Revised Guidelines on Action 8–10*, paras 1.164–1.166.

42 *Ibid.*, para. 1.167.

43 *Ibid.*, paras 1.164–1.166 & paras 7.12–7.13.

adjusted a few notches upwards to take into account implicit support.

20. It could be argued that, at arm's length, an independent lender would look into the standalone credit rating of the borrower. Accordingly, taking into consideration the parental affiliation to notch up the credit rating does not comply with the arm's length principle. However, it should be noted that associated enterprises enjoy benefits which are not available to market participants in uncontrolled transactions. Therefore, it makes perfect sense to adjust for implicit support[44]. The author agrees with the conclusion of the OECD examples and states that the standalone credit rating of an entity needs to be adjusted for implicit support for transfer pricing purposes. It could well be possible that the credit rating of the borrower is notched up (for example *Baa* to *A)* due to parental affiliation. The arm's length interest rate will then be determined using the *A* rating[45].

2.2.2 *Loan Terms and Conditions*

21. For the second step, in addition to ascertaining the standalone credit rating (as adjusted for implicit support)[46], the terms and conditions[47] of the related party loan such as the (1) market conditions at the time the loan was issued[48], (2) the amount and tenure of the loan[49], (3) the currency in which the loan was granted and the currency in which it is required to be repaid[50], (4) the seniority or subordination character of the loan[51], (5) the type of interest payment (fixed or floating)[52], (6) loan repayment schedule or pre-payment options[53] and (7) security offered by the borrower[54], needs to be analysed[55]. This analysis, under which the features of the related party loan are ascertained, serves as a foundation to undertake a comparability analysis to determine the arm's length interest rates. As previously discussed, these terms and conditions should also be on an arm's length basis taking into consideration the borrowers and lenders relevant economic characteristics[56].

2.2.3 *Benchmarking Interest Rates: Internal vs External Comparable Uncontrolled Prices*

22. The most common transfer pricing method applied to benchmark interest rates is the comparable uncontrolled price method (CUP). It may be possible to use internal CUPs[57]. In such situations one has to examine the borrowers third party funding arrangements and make appropriate adjustments to improve comparability[58]. Generally, when a borrower obtains third party debt that debt is usually senior to the related party debt. Accordingly, the interest rate paid on the third party debt would not often serve as an appropriate benchmark for the related party debt. Consequently, adjustments have to be made to take into account the subordination feature. Likewise, if a third party lender provides an

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44 *See* OECD Guidelines, para. 1.10; Averyanova & Sampat, *supra* n. 2, at 366.

45 *See* Balkus & Heath, *supra* n. 11, at 74–75; M. Breggen, *Netherlands* in *Transfer Pricing and Intra Group Financing* 430 (IBFD 2012).

46 The US treasury regulations also state that an arm's length rate of interest shall be '*a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. All relevant factors shall be considered, including the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties*'. *See* US Treasury Regulations. s. 1.482-2(a)(2)(i) (1994).

47 For features of a third party loan agreements *see* – Her Majesty Revenue and Customs, *Thin Capitalization: Practical Guidance*, INTM 522010.

48 It is essential that loans be benchmarked at the time they were issued as credit markets have been fluctuating tremendously since the credit crisis. Reyneveld & Bonekamp, *supra* n. 11, 232.

49 In general, long-term loans carry higher interest rates that increase further depending on the degree of subordination whereas short-term loans carry lower interest rates.

50 Interest rates vary depending on the currency of the loan. A loan provided in USD will not have the same return as a loan provided in Japanese Yen. Thus, currency is a key comparability factor.

51 Loans result in higher credit risks when they are subordinated. On the contrary, when they are senior to other loans, the credit risk and interest rates are lower.

52 Loans that are provided on a variable basis (adjusted annually) are exposed to lower interest rate risks as opposed to loans that are provided on a fixed interest basis.

53 Loans can include different types of options. For instance, the borrower may have the option (call option) to repay before the loan maturity or the lender may have the option (put option) to collect the loan before maturity. These options play an important role, in particular, in assessing the extent to which such options are exercised on an arm's length basis. The value of these options depends on market perceptions.

54 The credit risk of a loan decreases considerably when a borrower provides collaterals for a loan. Appropriate collaterals, in general, reduce the interest rates on loans.

55 Bakker, *supra* n. 1, at 28.

56 Ledure et al., *supra* n. 1, at 354.

57 OECD Guidelines, paras 3.27 & 3.28.

58 Bakker, *supra* n. 1, at 29; Reyneveld & Bonekamp, *supra* n. 11, at 231.

interest-bearing loan to a company belonging to the multinational group then that loan cannot be considered as a direct comparison to a loan provided by that third party lender to another member of the multinational group. This is because there could be differences in the credit worthiness of the related party borrowers. Consequently, adjustments have to be made to take into account the credit rating of the borrower. Moreover, a bankability letter i.e. letter from the bank (third party) offering a particular interest rate to the borrower, may not be considered as a comparable as it is not an actual transaction even though it provides good corroborative evidence[59].

23. If internal CUPs are not available, external CUPs[60] may be considered[61]. A benchmarking analysis can be carried out using information from publicly available databases such as Thomson Reuters Loan Connector, Deal Scan or Bloomberg, which provide information for third party loans[62]. The information should pertain to companies with credit ratings that are comparable to the related party borrower. Specifically, an appropriate screening process[63] needs to be defined taking into consideration the related party borrowers *economic circumstances*[64]. Ideally, the search would start by looking into the market circumstances when the loan was entered into, country of the borrower, the maturity & currency of the loan and the industry of the borrower. Subsequently, the other loan terms and conditions have to be considered. However, perfect external CUPs may not exist[65] and when suitable adjustments[66] cannot be made, other methods may need to be explored.

24. In some situations, information from yield curves such as the Bloomberg Fair Value Curve[67] has also been accepted (on an individual basis or as back up evidence to an external CUP analysis). In a nutshell, yield curves are based on market interest rate information on bonds for a large number of credit ratings, currencies and industries[68]. Such curves provide information on interest rates with maturities ranging from three months to twenty years. Essentially, the curve indicates at what price a bond should be traded based on comparable rated bonds and comparable maturities. In other situations, taxpayer's have also used the build-up approach. Essentially, this approach estimates a risk free rate such as London Interbank Offer Rate (LIBOR)[69] or Euro Interbank Offer Rate (EURIBOR)[70], to which an arm's length spread is added based on transaction specific risks or transaction specific factors such as covenants and subordinations. Corporate bond data may be used by making the appropriate adjustments[71].

25. Furthermore, it is remarked that some tax authorities apply legal interest rates[72] or domestic Prime Lending Rate (PLR)[73] as external CUPs to benchmark interest rate on cross-border loans. The application of such standard rates, in the author's opinion, is inappropriate, as it does not take into consideration the borrowers credit rating and the terms and conditions on which the loan is provided[74].

Notes

59 Reyneveld & Bonekamp, *supra* n. 11, at 231–232.

60 OECD Guidelines, paras 3.30–3.34.

61 Bakker, *supra* n. 1, at 29.

62 It is preferable to do the comparability analysis with data from the primary corporate loan market as opposed to data from secondary bond market. *See* J. Hollas & G. Hands, *Intercompany Financial Transactions: Selecting Comparable Data*, 18 Transfer Pricing Rpt. 1240 (2010).

63 OECD Guidelines, paras 3.40–3.46.

64 For a detailed external CUP analysis on pricing and designing intercompany debt *see*: T. Reichert, I. Gray, N. Callard & E. Hutchinson, *How to Accurately Price and Design Intercompany Debt* 1–37 (Economic Partners LLC, White Paper Series) (2012).

65 OECD Guidelines, paras 3.48–3.54.

66 For a discussion on adjustments to be made to third party comparables *see*: J. Hollas & G. Hands, *Comparability Adjustments: Finding an Arm's Length Interest Rate*, 18 Tax Mgt. Transfer Pricing Rpt. 9 (2009).

67 Bakker, *supra* n. 1, at 29; *Also see* O. Montero, *Forecasting Interest Rates for Future Intercompany Loan Planning: An Alternate Approach*, 16(5) Intl. Transfer Pricing J. 313–317 (2009).

68 Reyneveld & Bonekamp, *supra* n. 11, at 231.

69 *See* **http://www.global-rates.com/interest-rates/libor/libor.aspx (31 October 2016).**

70 *See* http://www.euribor-rates.eu/ (31 October 2016).

71 Russo & Moerer, *supra* n. 1, at 29.

72 M. Rasch, L. Moury & D. Pala, *Luxembourg Court Case on Intercompany Financing Increases Focus on Transfer Pricing*, 21(2) Intl. Transfer Pricing J. 107–109 (2014).

73 The rates at which the top Indian banks lend to customers. This system has been replaced by a base lending rate system. *See* http://timesofindia.indiatimes.com/business/india-business/RBI-changes-prime-lending-rate-system-to-base-rate/articleshow/5558281.cms (31 October 2016).

74 *See Cotton Naturals India Pvt. Ltd*, ITA No. 233/2014 (AY 2007–2008), 27 Mar. 2015.

In the following section, the author critically explores two Court judgments to check whether taxpayers follow the aforementioned process or not. If not, what is the outcome?

2.2.4 *Court Decisions on Intercompany Loans from a Transfer Pricing Perspective*

2.2.4.1 Finland: OY Case

26. Facts: The taxpayer (*Company OY*)[75], a Finnish company, belonged to a Nordic Group. The taxpayer engaged into two loans from a third party bank. The loans carried an interest rate of 3.25% and 3.135%. The securities that were offered as a collateral on this loan amounted to EUR 41 million. Pursuant to a group refinancing arrangement, the taxpayer paid off its bank loans by obtaining a credit facility from a related company in Sweden (*B AB).* The loan from the Swedish company carried an interest rate of 9.5%. This rate was determined on the basis of the average interest rates that *B AB* was required to pay to its creditors. Specifically, *B AB* had taken loans from unrelated parties (secured loans between 3.92% and 7.45% and unsecured loans between 12.53% and 16.50%) and related parties (shareholder loans at 17%). The securities that were offered as a collateral on this loan amounted to EUR 302 million. After the refinancing was completed, the taxpayer made an interest payment to *B AB.* The tax authorities considered the interest rate of 9.5% to be excessive and allowed a deduction of the payment only up to 3.25% (the interest paid by the taxpayer to the banks). The taxpayer appealed to the Adjustment Board of the Large Taxpayers Office. The adjustment board calculated the average interest rates that *B AB* was required to pay to unrelated parties (shareholder loans were excluded) and concluded that an interest rate of 7.04% is at arm's length. The Helsinki Administrative Court upheld this rate too. The tax authorities brought the case before the Supreme Administrative Court. The key question that arose in this case, from a Finnish transfer pricing perspective, was whether the average interest rate of 7.04% was at arm's length?

27. The judgment: The Supreme Administrative Court, after examining the facts of the case, held in favour of the tax authorities. The Court, firstly, observed the capital structure of the taxpayer did not change post the refinancing arrangement. Secondly, *B AB* did not provide any additional financial services (except refinancing) that would have justified a higher interest rate. Lastly, and more importantly, an interest rate of 7.04% cannot be justified when the taxpayer, based on its own credit worthiness, could have obtained a loan at cheaper rates. Therefore, the Court concluded that the interest rate of 3.25% which was payable to third party banks by the taxpayer has to be used as a benchmark and can be considered to be at arm's length.

28. Key issues: Several issues merit attention. Firstly, a taxpayer will enter into a refinance arrangement to take advantage of a better interest rate. However, in this case, the refinancing arrangement led to higher interest rate. Accordingly, it is questionable as to whether the refinancing arrangement was '*commercially rational*'? Secondly, it is also at odds that the interest rate charged to the taxpayer was high even though the provision of security increased substantially. Normally, appropriate collaterals reduce the interest rates on loans. Thirdly, the taxpayer calculated its interest rate on the basis of interest that was payable by the group. This clearly contrasts with the arm's length process for setting interest rates. Nevertheless, the Court's decision is reasonable as it held that the interest rate should be calculated on the basis of the taxpayers own credit worthiness. However, the Court did not discuss the impact of implicit support on the credit rating of the borrower. Overall, in the author's opinion, the Court did not approach this case in a structured manner and did not discuss several issues.

2.2.4.2 Australia: The Chevron Judgment

29. Facts: The taxpayer[76], an Australian company viz., Chevron Holding (CAHPL), owned a US company viz., Chevron Finance (CFC) with which it entered into a credit facility in June 2003. Under the credit facility CFC was required to provide a loan

Notes

75 The author did not manage to obtain a translation of this case in English. The analysis is based on an article published in a journal. *See* M. Raunio, *Supreme Administrative Court Ruling on Interest Rate Reflecting Creditworthiness of Individual Companies*, 18(4) Intl. Transfer Pricing J. 296–301 (2011).

76 *Chevron Australia Holding Pty v. Commissioner* (No 4) (2015), FCA 1092, 23 Oct. 2015. *Also see* M. Butler, J. Pengelly & R. Neilson, *Federal Court Hands Down Transfer Pricing Decision in Chevron Australia Case*, 23(1) Intl. Transfer Pricing J. 296–301.

to CAHPL. CAHPL was going to use the funds for repaying an existing debt and fund further development of its upstream business. The interest, which was payable monthly, was determined on the basis of 1 month Australian LIBOR-BBA plus 4.14% per annum (the interest rate effectively applied on the loan was 8.15%). The loan was repayable in five years with an option of early repayment. Further, CAHPL neither issued any security against the loan and nor did any group company, especially the ultimate US Parent (CVX), provide a financial guarantee to CFC. Moreover, the loan arrangement was not subject to any financial covenants. In order to meet its commitment under the credit facility, CFC borrowed funds from the US commercial market at 2% in United States Dollars (USD) and on lent it to CAHPL in Australian Dollars (AUD). Thereafter, the taxpayer made an interest payment to CFC. The tax authorities considered the interest payment to be excessive and disallowed a major part of the deduction (the taxable income was raised and penalties were levied). The key question that arose in this case before the Australian Federal Court, from a transfer pricing perspective, was whether the interest rate applied by the taxpayer was at arm's length (whether or not CFC should be entitled to the interest income is discussed in section 2.3.2)? The issue was analysed in light of Division 13 of the Australian Income Tax Act (1936) – applicable for the year up to July 2004 – and Division 815A of the Australian Income Tax Act (1997) – applicable from July 2004 to June 2013.

30. Re-characterization under Division 13: At the outset, the question arose under Division 13, as to whether the loan arrangement can be re-characterized? The tax authorities argued that, at arm's length, no lender would have provided a loan to CAHPL[77]. This was because the loan facility lacked financial covenants and appropriate securities. Moreover, CVX did not provide a guarantee to CFC on behalf of CAHPL[78]. Accordingly, the arrangement should be re-characterized to equity. However, due to the manner in which Division 13 was worded (it authorized only price adjustments by using the term '*consideration*') the Court held that the loan agreement between CAHPL and CFC should be used as a starting point. The Court seems to have accepted that a comparison should be made between the terms and condition of the related party loan with independent party loans[79]. Therefore, the loan arrangement was not recharacterized. Moreover, It was also argued that the funding should be denominated in USD as opposed to AUD as CFC, which operated in the American market, raised funds solely for the purpose of on-lending them. This issue was raised because the interest rates applicable to USD denominated loans were lower than AUD denominated loans[80]. However, the Court held that loan currency was in AUD. This was because the taxpayer had demonstrated that if the loan were taken in USD it would have been exposed to significant foreign exchange risks[81]. A key takeaway from this discussion is that structural adjustments can be made only if authorized by domestic law. Before entering into the discussion on comparables, the Court provided its comments on credit rating and implicit support.

31. Credit rating and implicit support: The tax authorities and various experts agreed that a credit rating analysis of the borrowing company had to be carried out to determine the arm's length interest rate. The Court agreed with this conclusion but held that the borrowers credit worthiness should be seen from the perspective of a commercial lender (such as a bank) as opposed to a credit rating agency[82]. The author has no issue with using the credit rating methodology of banks. However, such processes are not transparent. Thus, in the author's opinion, the Court is erroneous in disregarding the use of ratings issued by credit rating agencies. Credit rating agencies, by issuing a rating, also provide an accurate estimation of the borrowers debt capacity to meet its financial obligations on a timely basis. In fact, in a transfer pricing analysis, it is common practice to refer to credit ratings issued by rating agencies. Accordingly, they should not be disregarded. Moreover, the question arose as to whether an adjustment is required to be made to the borrower for the implicit support that it receives from being

Notes

77 *Chevron* (2015), para. 495.

78 *Ibid.*, para. 496.

79 *Ibid.*, para. 499.

80 *Ibid.*, para. 497.

81 *Ibid.*, para. 583.

82 *Ibid.*, para. 503. This was because sufficient evidence was presented to show that commercial lenders and rating agencies adopted different approaches to determine the credit worthiness of the borrower. *See Ibid.*, para. 254.

affiliated with a multinational group. The taxpayer argued that the credit rating should not be notched up on account on implicit support and only the standalone rating should be considered. The tax authorities on the other hand argued that group affiliations had to be factored in order to determine the arm's length price. The judge held that implicit support should be taken into consideration but its existence remains a matter of fact. Nevertheless, in the present case, implicit support had a very little impact on the pricing by a lender. This was due to the absence of an explicit financial guarantee by the parent company[83]. While the author's agrees with the statement that the existence of implicit support is a matter of fact, its disregard in the current case does not seem to be justified. It is the author's view that implicit support should be factored in the credit rating process (*see* section 2.2.1).

32. Comparables: The taxpayer had appointed several expert witnesses to the case. Mr Martin had estimated CAHPL to have a credit rating of weak BB[84]. In light of this rating, he was of the opinion that institutional investors (and not banks) would have provided loans to CAHPL, with spreads higher than what was charged by CFC. The spreads were determined on the basis of spreads applicable to institutional loans as adjusted for underwriting fees, lack of financial covenants, security and size premiums[85]. Moreover, another witness, Mr Gross, had estimated CAHPL to have a credit rating of B+. In light of this rating, he was of the opinion that if CAHPL had borrowed the funds from an independent party then the interest rate would have been 1 month Australian LIBOR-BBA (base rate) plus a spread of 4%. The spread was determined on the basis of the interest rate charged by institutional investors (and not banks) and adjustments made for lack of covenants, upfront fees and a discount for prepayment[86]. Both witnesses argued that the interest payment was at arm's length as CAHPL had paid a lower amount. However, the Court put aside the analysis of both witnesses. The independent party loans i.e. the comparables presented by both witnesses were inaccurate as the terms and conditions of the independent party loans were significantly different from the terms and conditions agreed between CFC and CAHPL. Specifically, they were differences because security and financial covenants exist in independent party loans whereas these were not reflected in the related party loans. Moreover, the independent party loans were for different tenors, different credit ratings, were provided in different industries and were provided in different markets[87]. The inability of the taxpayer to provide appropriate comparables clearly showed that the terms and condition to the related party loan facility did not exist between an independent lender and commercial borrower. As the taxpayer had failed to demonstrate the arm's length nature of the payment, the Court ruled in favour of the tax authorities. The case shows that high standards of comparability to benchmark interest rates using the CUP method.

33. Re-characterization under Division 815A: The Court ruled that the approach adopted in Division 815A was different from the approach in Division 13[88]. The Court ruled that the tax authorities can question not only the price of the transaction but also transaction conditions[89] (as this division used the term '*conditions*' as opposed to '*consideration*'). The Court concluded that if the level of debt in the related party transaction is higher than what independent parties would agree then the debt level of the related party transaction should be reduced[90]. As the taxpayer had failed to demonstrate the arm's length nature of the conditions, the Court ruled in favour of the tax authorities[91]. The author agrees with this line of reasoning in light of his previous analysis (*see* section 2.1.2).

Notes

83 *Chevron* (2015), para. 606.

84 *Ibid.*, para. 490.

85 *Ibid.*, para. 489.

86 *Ibid.*, para. 491.

87 *Ibid.*, paras 504–525.

88 *Ibid.*, para. 591.

89 *Ibid.*, para. 600.

90 *Ibid.*, paras 604–614.

91 *Ibid.*, para. 614.

2.3 *Lenders State: Allocation of Returns Based on Risks*

2.3.1 *The Illustration Fact Pattern*

34. Consider the following illustration: Company A (tax resident of State A) sets up Company B (tax resident of State B), an appropriately capitalized financing entity in a low tax European jurisdiction. Company B, which operates in Euros, is responsible to provide funding to group's entities. Among several transactions, Company B provides a loan facility of AUD 100 million to Company C (tax resident of Australia) at an interest rate of 8%. The *could* analysis indicates that the borrowers borrowing capacity can accommodate the loan. Moreover, *would* analysis indicates that the loan proceeds are used towards acquiring equipment necessary for the functioning of Company C. Accordingly; the loan arrangement is commercially justified. The interest rate, which can be considered to be arm's length rate, comprises of a risk free rate[92] of 0.25% and a risk adjusted rate[93] of 7.75%. The latter rate represents the financial risk borne by the lender. In effect, the financial risk comprises of the credit[94], interest rate[95] and foreign exchange[96] risk.

35. Under *Case 1*, Company B employs two finance professionals. These professionals are involved in loan creation[97] and loan management activities[98] for the entire group. These personnel report to the local board of directors (residents of State B) who, based on their inputs, approve the funding decisions. Under *Case 2*, Company B does not employ any professionals. Moreover, its directors, who are tax residents of State A, travel to State B once a year wherein they approve and formalize the funding decisions. These decisions are based on the analysis received by the finance team of Company A who, principally, perform the loan creation and loan management activities. The question analysed in this section is whether Company B should be allocated the financing return (interest income) in both cases?

2.3.2 *The Arm's Length Allocation of Risks and Returns*

36. The revised guidance provides that returns will be allocated to an entity that bears the associated risks[99]. In this regard, the following framework for analysing risks (*see* Table 1) is provided in order to accurately delineate the controlled transaction[100].

Table 1 Framework for Analysing Risks

Step 1	Identify the economically significant risk
Step 2	Understand which party bears the risk contractually
Step 3	Through a functional analysis determine which party assumes and manages the risk, in particular, which party controls the risk and has the financial capacity to bear the risk
Step 4	Understand whether the contractual assumption of risk consistent with the conduct of the parties
Step 5	If not, under this step, allocate the returns based on which party controls the risk and has the financial capacity to bear the risk
Step 6	Delineate the actual transaction

Notes

92 Risk free interest rate is a rate of return of an investment with no risk of financial loss.

93 Risk adjusted interest rate is a rate of return which calculates an investment return based on the associated risks.

94 Credit risk is a risk that the customer will not be able repay the principal and interest amounts. *See* OECD, *2010 Report on Attribution of Profits to a Permanent Establishment (OECD Attribution Report)* 68 (OECD 22 July 2010).

95 Interest rate risk is a risk that the market interest rates will fluctuate in comparison to the rates used when the intercompany loan agreement was negotiated. *See OECD Attribution Report*, 68.

96 Foreign exchange risk is a risk that arises from movements in exchange rates for loans denominated in foreign currencies. *OECD Attribution Report*, 68.

97 Creation of loans involves the following activities (inclusive list): 1) negotiating the terms and conditions, 2) evaluating the various financial risks associated with the loan, 3) analysing the credit worthiness of the borrower, 4) undertaking the steps to price a loan, 5) deciding on whether collateral or securities are required & 6) undertaking steps to formalize the loans etc. *See OECD Attribution Report*, 65.

98 Managing of loans involves the following activities (inclusive list): 1) undertaking loan support functions such as collecting the interest, monitoring repayments, determining the value of collaterals, 2) monitoring the financial risks on an ongoing basis by reviewing the credit worthiness of the borrower, analysing market interest movements, analysing the profitability of the loan, 3) undertaking necessary steps to hedge risks associated with the loan & 4) deciding on whether refinancing the loan is required or not etc. *See OECD Attribution Report*, 65.

99 *OECD Revised Guidelines on Action 8–10*, paras 1.56–1.59. *Also see* I. Verlinden, D. Ledure & M. Dessy, *The Risky Side of Transfer Pricing: The OECD Base Erosion and Profit Shifting Reports Sharpens the Rules on Risk Allocation under the Arm's Length Standard*, 23(2) Intl. Transfer Pricing J. (2016), *published online*, s. 3.

100 *OECD Revised Guidelines on Action 8–10*, para. 1.60.

37. In the above illustration, under both *cases*, financial risk can be regarded as the economically significant risk[101]. Further, the lender bears the risk contractually[102]. Moreover, after undertaking a functional analysis[103] in *Case 1*, a strong argument can be made that Company B should be entitled to the entire financing return of 8%. This is because that entity controls[104] the financial risk through its employees. Specifically, Company B employs personnel and these personnel's functions demonstrate that they have the capability to make decisions with respect to (1) taking on, laying off or declining financial risks and (2) deciding on whether and how to respond to the various financial risks associated with the decisions making opportunity. Moreover, the entity also demonstrates that it can perform the decision-making activity associated with the risks. Furthermore, even if the management of risks is outsourced, the personnel in Company B have the capability to demonstrate that they can oversee and manage the outsourced risks[105]. Additionally, Company B has the financial capacity[106] to bear the risk (for instance, Company B has the necessary funds to assume and mitigate this risk by entering into hedging transactions such as credit default swaps).

38. Under *Case 2*, the functional analysis would indicate that Company B does not carry out any loan creation or management activities. Consequently, the contractual assumption of the financial risk is not in line with the conduct of the parties. In the context of cash boxes[107], the revised guidance has made it clear that if an entity does not control[108] the financial risks over the debt funding but simply acts on the direction of other members of the multinational group then (1) that entity will not be attributed the profits linked to the financial risks and as a consequence will be entitled to no more than a risk-free return or, (2) less than a risk free return if, for instance, the transaction is not commercially justified and therefore the non-recognition rules apply[109]. As a result, Company B should be entitled only to a risk free return of 0.25% or even a lower return if the transaction is disregarded. Thus, Company A shall be allocated the risk. The allocation of risks under both cases is based on the proposed framework is highlighted in Table 2.

Table 2 Allocation of Risks and Return

		Case 1	***Case 2***
Step 1	Financial risk which comprises of credit, interest rate and foreign exchange risk is identified as an economically significant risk		
Step 2	Which party bears the financial risk contractually	*Company B*	*Company B*
Step 3	Which party controls the risk and has the financial capacity to bear the risk	*Company B*	*Company A*
Step 4	Is the contractual assumption of risk consistent with the conduct of the parties	*Yes*	*No*
Step 5	Allocate the returns based on which party controls the risk and has the financial capacity to bear the risk	*Company B is allocated the financial risk and the associated return*	*Company A is allocated the financial risk and the associated return (at most Company B shall be allocated a risk free return)*

Notes

101 For an overview of the various economically significant risks *see OECD Revised Guidelines on Action 8–10*, paras 1.71–1.76.

102 For a discussion on contractual assumption of risks *see OECD Revised Guidelines on Action 8–10*, paras 1.77–1.81.

103 The functional analysis serves as a basis to understand which parties assume or manage the risk, in particular, 1) which enterprise performs the control and risk management function, 2) which enterprise encounters the upside or downside or risk outcomes & 3) which enterprise has the financial capacity to bear the risks. *See OECD Revised Guidelines on Action 8–10*, paras 1.82–1.85.

104 *See* OECD Guidelines, paras 9.22–9.28; The revised guidance elaborates on this and provides that control over risk involves '*(i) the capability to make decisions to take on, lay off, or decline a risk-bearing opportunity, together with the actual performance of that decision-making function and (ii) the capability to make decisions on whether and how to respond to the risks associated with the opportunity, together with the actual performance of that decision making function. It is not necessary for a party to perform the day-to-day mitigation … in order to have control of the risks. Such day-to-day mitigation may be outsourced*'. *See OECD Revised Guidelines on Action 8–10*, para. 1.65, para. 1.69 & para. 1.70; Bullen, *supra* n. 5, at 496–507.

105 *OECD Revised Guidelines on Action 8–10*, para. 6.63; *Also see* Example 6, Ch. VI, *OECD Revised Guidelines on Action 8–10*, 119–120.

106 *See* OECD Guidelines, paras 9.29–9.32. The revised guidance elaborates on this and provides that the financial capacity to assume risk '*can be defined as access to funding to take on the risk or to lay off the risk, to pay for the risk mitigation functions and to bear the consequences of the risk if the risk materializes*'. *See OECD Revised Guidelines on Action 8–10*, para. 1.64; *Also see* Bullen, *supra* n. 5, at 482–497.

107 Such entities have been defined as '*capital rich entities without any other relevant economic activities*'. *See OECD Revised Guidelines on Action 8–10*, 11.

108 If the directors of Company B formalize the funding decision in State B by holding local meetings, documenting minutes and signing documents, although the funding decision was made in State A, then it is clearly stated that the decision making function exercised by the directors does not qualify as an exercise which demonstrates control over the risks. *See OECD Revised Guidelines on Action 8–10*, para. 1.66.

109 *OECD Revised Guidelines on Action 8–10*, para. 1.85 & para. 1.103. *Also see* Example 16, Ch. VI, *OECD Revised Guidelines on Action 8–10*, 129–130.

39. The facts of *Case 2*, from the lenders perspective, resemble the facts of the Chevron judgment. In that case, CFC had provided a loan to CAHPL. It should be noted that Mr Dalzell, an internal employee of the Chevron group, confirmed that CFC did not have any staff of its own. CVX's treasury team undertook all decisions with respect to its activities[110]. Therefore, the question can be raised as to whether CFC should be entitled to any interest income? If one applies the aforementioned OECD view, the answer should be in the negative. The financial risk should be allocated to CVX. It is indicated that CAHPL has appealed to the Australian Full Federal Court. The author suggests the Court to analyse as to whether CVX should be allocated the interest income from a transfer pricing perspective under Australian transfer pricing rules.

2.4 *Intercompany Loan Agreements*

40. As a best practice, it is recommended that multinationals prepare appropriate legal documentation for intercompany loans[111]. A lesson can be learnt from the *Chevron* case is that related party loans should be structured in the same manner as unrelated party loans. It the agreement lacks certain clauses (such as security, financial covenants, clarity on subordination), tax authorities may attribute that clause and could either re-write the agreement or deny associated interest deductions. Thus, intercompany loan agreements need to be drafted/re-drafted or even modified in an appropriate manner as the agreement serves as a starting point to justify the nature of the taxpayer's dealings in transfer pricing audits. If not, tax disputes on intercompany loans will rise[112].

2.5 *The Master File, Local File and Country by Country Reporting*

41. Action 13 of the BEPS plan seeks to enhance transparency in transfer pricing matters by ensuring that multinational companies disclose to all the relevant governments with information with respect to their global allocation of income, economic activities and taxes paid among countries according to a common template. Essentially, a master file, local file and country-by-country reporting template is proposed[113]. The role of the master file is to provide high level information about the multinational group such as the organizational structure, description of business and what drives value in it, intangible assets, intercompany financial transactions[114] and the multinationals financial and tax positions. The role of the local file is to provide a detailed analysis of the application of the arm's length principle with respect to the transactions that take place between the local country affiliate and the associated enterprises in different countries. The country-by-country report, which is required to be filed annually, requires multinationals to provide information (such as revenues, profit before taxes paid, employees etc.) for each tax jurisdiction in which they operate[115]. Moreover, at the EU level, a similar initiative on automatic exchange of country-by-country reporting has been proposed and adopted[116]. Consequently, intra-group financial transactions will have to be reported pursuant to these documentation requirements. The disclosures will provide a comprehensive view to the tax authorities on how a multinational organizes its financing activities[117].

Notes

110 *Chevron* (2015), para. 119.

111 Russo & Moerer, *supra* n. 1, at 15.

112 V. Chand & S. Wagh, *The Profit Split Method: Status Quo and Outlook in Light of the BEPS Action Plan*, 21(6) Intl. Transfer Pricing J. 406 (2014).

113 Y. Brauner, *Transfer Pricing in BEPS: First Round – Business Interests Win (But, Not in Knock-Out)*, 43(1) Intertax 79–84.

114 The multinational has to provide information on 1) how the group is financed and its important financial arrangements, 2) centralized treasury activities, if any 3) a description of the transfer pricing policies related to the financial arrangements. *OECD Revised Guidelines on Action 13*, 26.

115 *Ibid.*, at 9.

116 *See* EU Commission, *Proposal for a Council Directive Amending Directive 2011/16/EU as Regards Mandatory Automatic Exchange of Information in the Field of Taxation* (EU Commission 28 Jan. 2016) followed by EU Commission, *Council Directive (EU) 2016/881 Amending Directive 2011/16/EU as Regards Mandatory Automatic Exchange of Information in the Field of Taxation (*EU Commission 25 May 2016).

117 P. Janssens, D. Ledure, B. Vandpitte & J. Loos, *The End of Intra Group Financing … or Not Just Yet ? – Part 2*, 55(8) Eur. Taxn. 349–351 (Aug. 2015).

3 The impact of other BEPS developments and their relationship with transfer pricing rules

3.1 *Introductory Comments*

42. Intercompany loans are often considered in the context of tax optimization because interest is generally deductible under the tax laws of most countries. Considering the high mobility of capital, the impact of intra-group loans on the effective tax rate is further optimized by multinationals having entities in jurisdictions with favourable tax regimes or low corporate tax rates. In the following sections, the author discusses the impact of other BEPS related actions on intercompany loans. Included in the analysis are the various developments at the EU level, in particular, the proposals put forward by the EU Commission on fighting tax avoidance practices i.e. the anti-tax avoidance directive proposing amendments to domestic law[118] and the recommendation proposing amendments to tax treaties concluded by EU Member States[119]. Moreover, their relationship with transfer pricing rules is discussed.

3.2 *The Borrowers Perspective*

3.2.1 *Limiting Interest Deductions*

43. Action 4 of the BEPS Plan[120] deals with limiting interest deductions[121]. Essentially, the final report provides recommendations in designing domestic law rules to prevent base erosion through the use of (excess) interest expenses. A fixed ratio rule is recommended to restrict interest deductions. The rule restricts the interest payment of an entity of a group to a percentage of that entities earning before interest, taxes, depreciation and amortization (EBITDA). The recommendation leaves open the possibility for countries to choose a percentage between 10–30% based on certain parameters[122]. Furthermore, the report recommends countries to incorporate a group ratio rule alongside the fixed ratio rule. This approach would enable entities with net interest expense above a country's fixed ratio rule to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group. Likewise, at the EU level, Article 4 of the anti-tax avoidance directive provides for a similar interest limitation rule[123]. These developments could restrict interest paid by entities even if the funding and corresponding payments are at arm's length[124]. Consequently, intercompany financing (depending on the structure adopted by the taxpayer) may result in double taxation as interest income may be fully taxable in the country of the creditor and the corresponding interest expense may be non-deductible in the State of the debtor[125]. Nevertheless, the double taxation could be minimized if the excess interest is carried forward[126].

3.2.2 *Hybrid Mismatches*

44. Multinationals on several occasions have used complex financial instruments that have features of equity and debt (hybrid instruments) and entities that have features of partnerships and corporations (hybrid entities) to optimize on their taxes. Essentially, taxes were optimized using differences in countries domestic laws with respect to such instruments and entities[127]. Action 2 of the BEPS Plan[128] deals with eliminating such mismatches. Part I of the report provides for domestic law provisions that can be used by States to neutralize mismatches under which payments (including interest) are deductible in one State and non-taxable in another State. Essentially, the report suggests linking rules that align the tax treatment

Notes

[118] EU Commission, *Council Directive (EU) 2016/1164 Laying Down Rules Against Tax Avoidance Practices That Directly Affect the Functioning of the Internal Market* (EU Commission 12 July 2016).

[119] EU Commission, *Council Recommendation (EU) 2016/136 on the Implementation of Measures Against Treaty Abuse* (EU Commission 28 Jan. 2016).

[120] OECD/G20, *BEPS, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report* (OECD/G20 05 Oct. 2015).

[121] E. Millan & M. Roch, *Limit Base Erosion via Interest Deduction and Others*, 43(1) Intertax 58–60 (2015).

[122] OECD, *supra* n. 120, at 11.

[123] EU Commission, *supra* n. 118, Art. 4. *Also see* Millan & Roch, *supra* n. 121, at 65–67. The author's discuss the impact of EU law on interest deduction rules.

[124] Millan & Roch, *supra* n. 121, at 69–71; *Also see* J. Hülshorst et al., *Transfer Pricing Implications of Action 4 Under the OECD's BEPS Initiative*, 23(2) Intl. Transfer Pricing J. (2016), *published online*, s. 4.

[125] P. Janssens, D. Ledure, B. Vandpitte & J. Loos, *The End of Intra Group Financing … or Not Just Yet ? – Part 1*, 55(7) Eur. Taxn. 280–284 (July 2015).

[126] OECD, *supra* n. 120, at 68–70.

[127] R. Boer & O. Marres, *BEPS Action 2: Neutralizing the Effects on Hybrid Mismatch Arrangements*, 43(1) Intertax 14–21 (2015).

[128] OECD/G20, *BEPS, Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report* (OECD/G20 05 Oct. 2015).

of an instrument or entity[129] with the tax treatment in the other jurisdiction. A rule order in the form of a primary rule and a secondary or defensive rule is put forward. Under the primary rule, a Contracting State may deny the taxpayer a deduction for a payment to the extent that it is not included in the taxable income of the recipient in the other Contracting State or it is also deductible in the other Contracting State. If a State does not apply the primary rule then the other Contracting State can generally apply a defensive rule, requiring the deductible payment to be included in income or denying the duplicate deduction depending on the nature of the mismatch[130]. Similarly, Article 9 of the anti-tax avoidance directive recommends Member States to adopt similar linking rules to counteract hybrid mismatches[131]. These developments could restrict interest deductibility even if the funding and corresponding payments are at arm's length[132].

3.3 *The Lenders Perspective*

3.3.1 *Controlled Foreign Company Rules*

45. The issue of controlled foreign companies (CFC) is dealt in Action 3 of the BEPS plan[133]. The report provides recommendations in the form of building blocks for designing CFC rules. Essentially, building blocks with respect to (1) definition of a CFC, (2) CFC exemption and threshold requirements, (3) definition of CFC income, (4) computation of CFC income, (5) attribution of the CFC's income to the shareholder and (6) rules regarding preventing double taxation are provided[134]. The report provides countries the flexibility to design their CFC rules taking into consideration their overall policy objectives. Within the EU, the European Court of Justice (ECJ) case law, in particular, the *Cadbury Schweppes*[135] judgment restricts the application of CFC rules to only wholly artificial arrangements. The OECD has recognized that a conflict can arise between CFC rules and the EU freedom of establishment/capital and has put forward several suggestions to avoid such conflicts (such as a substance analysis or extension of CFC rules to domestic and cross-border subsidiaries)[136]. Similarly, Article 7-8 of the anti-tax avoidance directive recommends Member States to adopt CFC rules with respect to entities that can be considered wholly artificial or if the entities engage in non-genuine arrangements[137]. It could well be possible that income (interest income) derived by intermediary entities, even though they are at arm's length, could be subject to CFC rules of their parent State thereby leading to economic double taxation[138].

3.3.2 *Denial of Treaty Benefits*

46. Action 6 of the BEPS plan[139] deals with preventing treaty abuse. The final report suggests countries to incorporate a minimum standard by changing the title and preamble of their treaty to reflect the objective of preventing tax evasion and tax avoidance (including treaty shopping) coupled with either (1) a principal purpose test (PPT rule) and limitation of benefit (LOB) clause or (2) a LOB clause with a narrow PPT rule for conduit financing situations or (3) only the PPT rule[140]. Furthermore, the report suggests other treaty related changes to

Notes

129 C. Kahlenberg, *Hybrid Entities: Problems Arising from the Attribution of Income Through Withholding Tax Relief – Can Specific Domestic Provisions be a Suitable Solution Concept?*, 44 (2) Intertax 146–162 (2016).

130 *See* OECD, *supra* n. 128, at 11–12. *Also see*: Boer & Marres, *supra* n. 127, at 21–33.

131 *See* EU Commission, *supra* n. 118, Art. 9; *Also see* Boer & Marres, *supra* n. 127, at 21–33. The author's discuss the impact of EU law on hybrid mismatch rules.

132 Within the EU, an amendment has already been made to the Parent – Subsidiary directive to deal with the issue of hybrid financing. The amended version provides that no tax exemption is granted for hybrid loan payments that are deductible in the source Member State. *See* Council of European Union, *Council Adopts Amendment Closing Tax Loophole for Corporate Groups*, Brussels, 8 July 2014. Moreover, a general anti abuse clause has been added. *See* Council of European Union, *Council Directive Amending Directive 2011/96/EU on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States*, Brussels, 17 Dec. 2014.

133 *See* OECD/G20, *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report* (OECD/G20 05 Oct. 2015).

134 *Ibid.*, at 9.

135 ECJ: *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Case No: C-196/04, 12 Sept. 2006.

136 OECD, *supra* n. 133, at 17–18.

137 EU Commission, *supra* n. 118, Art. 7–8.

138 Excluded from the CFC pick up would be genuine financing entities operating in the EU that are held by EU parents). *Also see* Janssens, Ledure, Vandpitte & Loos, *supra* n. 117, at 343–348.

139 OECD/G20, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report* (OECD/G20 05 Oct. 2015).

140 *Ibid.*, at 10.

combat other tax avoidant structures (typically rule shopping)[141]. Moreover, at the EU level, EU Commission recommends Member States to insert the PPT rule in their treaty network[142]. It could well be possible that a lender within a multinational group does not satisfy the stringent requirements of the LOB clause in order to qualify as a resident of a Contracting State due to its light economic substance and the fact that it derives or pays interest from/to external jurisdictions. Furthermore, even if the taxpayer satisfies the LOB clause, depending on the facts and circumstances, it may not satisfy the subjective and objective requirements of the PPT rule[143]. Accordingly, arm's length interest paid to such entities could be exposed to high withholding taxes in the State of source if treaty benefits are denied[144].

3.3.3 *Harmful Tax Regimes and Tax Rulings*

47. Action 5 of the BEPS plan[145] deals with counteracting harmful tax competition taking into consideration transparency and substance. The final report states that the OECD/G20 countries agree to strengthen the '*substantial activity requirement*' that has been used to assess preferential tax regimes. Specifically for Intellectual Property (IP) box regimes, the report proposes the nexus approach. Under this approach, profits made by taxpayer utilizing an IP box regime are exempt only to the extent the taxpayer itself incurs the qualifying research and development (R&D) expenses that gave rise to the IP income. The idea behind the requirement is that the taxpayer should actually carry out the activity and incurs the related expenses in order to benefit from these regimes[146]. This requirement has also been extended to non–IP regimes[147]. Accordingly, taxpayers can benefit from other regimes, such as financing regimes[148], to the extent that the taxpayer itself undertook the '*core income-generating activities*' required to produce the type of income covered by the financing regime. Such activities could include loan creation and loan management activities[149]. This would imply that the entity has well qualified & knowledgeable staff that can make decisions with respect to the financial risks (*see* section 2.3). Accordingly, in the author's opinion, convergence exists between the notion of '*control over risks*' and '*core income-generating activities*' as put forward by the OECD.

48. Moreover, to promote transparency, the final report suggests States to exchange information on preferential tax rulings on a compulsory spontaneous basis in order to avoid BEPS concerns. Such rulings include rulings on preferential regimes (such as financial regimes) or unilateral advance pricing arrangements (APA) in respect of transfer pricing[150]. At the EU level, the impact of EU State Aid rules[151] on tax rulings, in particular, rulings dealing with transfer pricing arrangements are gaining importance. The EU Commission has been contesting that States which have granted taxpayers (such as Fiat[152]) unilateral APA's are providing illegal State Aid. If proven to be true, the concerned State will have to recover the amount of aid plus interest for up to ten years[153].

4 The way forward

4.1 *Recommendation*

49. Transfer Pricing issues with respect to intragroup finance is a leading area of controversy[154]. As

Notes

141 *Ibid.*, at 10.

142 *See* EU Commission, *supra* n. 119.

143 *See* L.D. Broe & J. Luts, *BEPS Action 6: Tax Treaty Abuse*, 43(2) Intertax 131–134 (2015).

144 Janssens, Ledure, Vandpitte & Loos, *supra* n. 125, at 286–290.

145 *See* OECD/G20, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report* (OECD/G20 05 Oct. 2015).

146 *Ibid.*, at 22–36.

147 *Ibid.*, at 37.

148 J. Malherbe, *Harmful Tax Competition and the Future of Financial Centres in the European Union*, 30(6–7) Intertax 221–224 (2015). The author examines the compatibility of the Belgian Co-ordination Centres, Dutch Finance companies and Irish Financial Service companies with the harmful tax criteria issued by the OECD and EU. *Also see* R. Szudoczky & J. Streek, *Revisiting the Dutch Interest Box Under the EU State Aid Rules and the Code of Conduct: When a 'Disparity' Is Selective and Harmful*, 38(5) Intertax 260–280 (2010).

149 *See* OECD, *supra* n. 145, at 38.

150 *See Ibid.*, at 45–59.

151 Arts 107–109*, Treaty on the Functioning of the European Union. Also see* R. Luja, *Harmful Tax Policy: When Political Objectives Interfere with State Aid Rules*, 31(12) Intertax 484–488 (2003).

152 *See* EU Commission, *State Aid SA. 38375, Alleged Aid to FFT* (11 Nov. 2014).

153 *See* L.D. Broe, *The State Aid Review Against Aggressive Tax Planning: 'Always Look a Gift Horse in the Mouth'*, 24(6) EC Tax Rev. 290–293 (2015).

154 *See* T. Borstell, L. Ponds, J. Hobster & C. Viard, *Navigating the Choppy Waters of International Tax, EY's 2013 Global Transfer Pricing Survey* 25 (2013).

limited guidance exists on this topic, the OECD, in Action 4 of the BEPS plan has indicated that further work will be undertaken with respect to transfer pricing aspects of financial transactions (in 2016 and 2017). The guidance is expected to be on '*pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements*'. As a start, the OECD may want to use the author's analysis (*see* section 2), in drafting its guidance on topics dealing with financial intra-group transactions (in particular loan arrangements)[155]. It is also essential that the OECD highlights to States that Article 9(1) by itself does not authorize structural or valuation adjustments for intercompany loans. Such adjustments have to be authorized by the domestic law. Thus, the author also suggests the OECD to recommend domestic legislation that can give effect to arm's length adjustments.

4.2 *Transfer Pricing Disputes*

50. The Court judgments discussed in this contribution clearly show the tax authorities have started questioning the arm's length nature of intercompany loans. The areas in which transfer pricing disputes can be expected are (1) terms and conditions reflected in related party loans that are not found in independent party loans – thereby leading to non-recognition of the loan transaction, (2) disagreements on the credit ratings used by the taxpayer, (3) using internal or external CUP's without making suitable adjustments, (4) the screening data used for conducting an external CUP analysis may not reflect the related borrowers economic conditions and (5) using interest rates set by banks or financial institutions as an external comparable. Accordingly, in order to avoid transfer pricing disputes, large taxpayers should consider entering into unilateral or preferably bilateral advance pricing agreements (or even when possible a multilateral advance pricing agreement) with the relevant jurisdiction(s)[156]. Further, for arrangements that are already in litigation, taxpayers should evaluate the possibility of entering into a mutual agreement procedure (MAP) pursuant to treaties that contain Article 25 of the OECD Model[157] (or arbitration)[158].

Notes

155 Also for financial guarantees *see* Averyanova & Sampat, *supra* n. 2. For cash pooling *see* Chand, *supra* n. 3.

156 *See* P. Jain & V. Chand, *Location Savings: International and Indian Perspective*, 43(2) Intertax 196–197 (2015).

157 Art. 25 of the OECD Model provides for a dispute resolution mechanism that is also applicable for transfer pricing disputes.

158 The current MAP process provides for an optional arbitration mechanism. However, the MAP process is considered to be ineffective as many cases go unresolved. Action 14 of the BEPS plan seeks to make dispute resolution mechanisms more effective. The final report provides for implementation of minimum standards through a peer-based monitoring mechanism. In addition to committing to the minimum standard, several countries have also expressed their interest to implement mandatory arbitration clauses in their tax treaties. *See* OECD/G20, *BEPS, Making Dispute Resolution Mechanisms More Effective, Action 14* 9–10 (OECD/G20 05 Oct. 2015); *Also see* J. Malherbe, *The Issues of Dispute Resolution and Introduction of a Multilateral Treaty*, 43(1) Intertax 91–93 (2015).